THE ACCOUNTING VIEW OF THE NATURE OF BUSINESS TRANSACTIONS

BY
JAMES MARKHAM CARRITHERS
A.B., Coe College, 1936
M.S., Iowa State College, 1937
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SUBMITTED IN PARTIAL FULFILLMENT OF THE REQUIREMENTS
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THE ACCOUNTING VIEW OF THE NATURE OF BUSINESS TRANSACTIONS

Business transactions are the fundamental data of accounting. The function of accounting is to provide relevant information concerning the business transactions of a specific business enterprise for the use of those parties who are interested in the business enterprise. Transactions are basic and primary for the conduct of business. The accounting mechanism exists for the purpose of presenting well the results of the transactions that transpire in the course of the operation of a business. The justification of accounting procedure lies in its ability to make accurate, trustworthy, factual data understandable.

In the development of accounting as the agency whereby business facts are made intelligible, it is natural that certain problems arise for which the accountant must provide solutions. Business transactions must be translated into homogeneous terms. This must be done in the light of accounting function as modified by certain accounting concepts and conventions. Often several alternate solutions are possible. Thus, there arises a controversial area. It is the viewpoint of this study that only by adopting a scientific, theoretical approach can an adequate basis be had for solving the accounting problems of business transactions. A scientific approach includes the establishment of general concepts based upon ideas of function, utility and disinterest. A scientific approach attempts to exclude bias, self-interest, arbitrary judgment and unjustified rules.

Basic to any scientific solution is an understanding of the actual facts involved in the situation. A careful analysis of the nature of the business transactions involved in a given case will always be the important starting place for the accounting solution. If the process of analyzing transactions can be organized about their origin, development and final expiration, a framework can be constructed for the desired

scientific approach. An understanding of the nature of business transactions in general can help to improve the accounting for specific transactions. In this way the analysis of the specific facts of a given situation can be related to a well devised method of approach.

In this study it is believed that the facts in a transaction should control the accounting treatment. This is the scientific approach. The effect of the transaction sometimes is given more importance than the nature of the transaction as the determinant of the accounting treatment. If accounting is to grow in stature as a well-coordinated, scientific mechanism, accounting procedures should become more firmly based upon the facts and less dependent upon the results that emerge.

With this belief in mind it is the intention in this study to examine the activities of business in order to develop a concept of the nature of transactions in general . This examination will serve to clarify certain meanings and ideas relative to the transaction itself and also relative to the transaction as an integral part of business operation. Thus the discussion of the implications and relationships of specific transactions will become more meaningful.

Before we can appraise the facts or the effects of a given situation we should understand certain fundamentals of business and accounting. The fundamentals of business are the activities and exchanges of business. The fundamentals of accounting are the purpose, concepts and conventions of accounting.

Accountants have developed certain concepts and rules to aid them in the performance of their function. For the most part these concepts and rules are directed toward the record-treatment of business transactions. Taken together these concepts and rules may be thought of as a philosophy which deals fundamentally with three important questions: (1) What are business transactions? (2) How shall information concerning business transactions be recorded? (3) At what time should the business transactions be reflected in the accounting records?

Accounting deals with a body of data, business transac-

tions. The first consideration is the choice of data. The first question to be answered is what are the transactions that are to be recorded? The next consideration is one of technique. How shall the business transactions be recorded in order to best accomplish the purpose of accounting? The third question is one of timing. The timing of accounting recordings is an important requisite of proper transaction record-treatment because most quantitative business information is incomprehensible except as it is segregated into time-intervals.

All of these questions are interdependent and complementary. Properly answered they furnish a basis for measuring quantitatively many important actions of a business enterprise. The question of how much (income, property, liability, ownership) is answerable only after these other questions have been answered satisfactorily.

What are Business Transactions?

The general nature of business transactions cannot be briefly disposed of by a short definition. Business transactions are too complex and varied for simple treatment. It is helpful, however, to discuss the ideas or concepts that are basic in the term business transactions.

Business transactions are phases of human action. Human activities include, social activities, religious activities, domestic activities, economic activities, recreational activities, etc. Economic activities therefore are but one class of human activities and business activities are phases of economic activities. Business activities include all activities pursuant to the formation, operation and conduct of a business enterprise. Many of these activities result in the consummation of business transactions. Other activities do not. Business transactions are actual, quantitative, measurable business actions. Some business actions have not at a given moment reached a measurable stage. Although they are business activities, they are not yet business transactions. Therefore, it is possible to conclude that all business transactions are business activities, but not all business activities are business transactions.

Business activities may be classified as follows:

I. Direct (the activities in which the enterprise takes a direct part).
   (1) Business transactions.
   (2) Activities that are not business transactions.

II. Indirect (the activities in which the enterprise takes no direct part but which influence the direct activities of the enterprise).

Accounting acts to record, analyze, interpret and summarize business transactions rather than business activities. Activities which are not transactions are non-accounting data in the sense that they need not be recorded in the accounts. However, they are still useful to the accountants; their implications and effects should not be disregarded.

Business transactions, as distinguished from other business activities, are exchanges of goods and/or services and/or claims to goods and services between business entities. Exchange is fundamental to the idea of a business transaction. Basically goods and services are exchanged. However, actual exchanges are often represented by claims to goods and services (contracts) as part of the transaction.

It is believed that more light can be shed upon the nature of transactions if a sample classification of typical exchanges is presented. This should make more clear the meanings underlying business transactions.

Business transactions may be classified as follows:

I. Accumulation or Acquisition Exchanges

1. Financial accumulations

   a. Ownership-investments
   b. Long-term creditor-investments
   c. Short-term creditor-investments

2. Productional accumulations

   a. From the furnishing of goods
   b. From the furnishing of services

3. Other non-financial and non-productional accumulations

   a. Sale of permanent property or investments

b. Gifts and bequests*
c. Discoveries and natural accretions*

II. Functional or Use Exchanges

1. Productional
2. Non-Productional

III. Distribution or Disposition Exchanges

1. Distributions to financial contributors

a. Return of original contribution
b. Excess distribution (interest, profits)

2. Productional dispositions

a. In furnishing goods
b. In furnishing services

3. Other Dispositions

a. In disposing of permanent property or investments
b. Donations made*
c. Losses from theft or waste*
d. Losses caused by forces of nature*

IV. Equity Exchanges

1. Exchange of contracts within the same equity group
2. Exchange of contracts among different equity groups

This discussion of "What are business transactions?" represents the first aspect of the development of the proposition that the facts in a transaction are the preferable determinants as to the best solutions. The proper starting place for this development is the examination of underlying business ideas. The next step is to relate these basic ideas to accounting purpose and technique.

*These are not transactions according to a strict interpretation of the definition of transactions. They might be called quasi-transactions. It seems preferable, however, to include them here because of their nature as accumulation or diminution events.

How shall information concerning business transactions be recorded?

Before discussing the technique of how to record the information concerning business transactions it seems important first to dwell upon the purpose or function of accounting. The function of accounting should be understood in order that the more specific problem of how to record business transactions can be expressed in a coherent fashion.

The overall function of accounting has been stated as that of providing significant, organized information concerning business transactions. The mere recording of business transactions obviously provides information. The number and variety of business transactions precludes in most cases the possibility of remembering or of even being exposed to all the transactions of any one concern. The deficiencies of human memory and human capacity necessitate a record of business facts. Accounting answers this need for information, and, furthermore, adds significance to this data by organization. Accounting function is really a mixture of recording and analysis. The two are inseparable. Business transactions are not recorded in accounting without also being analyzed. Likewise, business transactions are not analyzed in accounting without also being recorded. It is incorrect to speak of the recording function of accounting or the analytical function of accounting as separate and distinct functions. Any formal accounting entry results in both functions being served. With this conclusion in mind it is perhaps more correct to speak of the recording phase of accounting function or the analytical phase of accounting function.

In the early days of business, accounting served business more as a recording device with little emphasis on the interpretative side. With the growth and integration of business organizations, more and more importance has been attached to the interpretative phase of accounting function.

With the increased development of interpretation in accounting, there has arisen the danger of over-emphasis of this analytical phase. Sometimes the general purpose of account-

ing, that of providing significant information concerning the business transactions of an enterprise to all interested parties, is subordinated to the special purpose of providing information of significant benefit to one group of interested parties. This does not mean that special objectives should be ignored. They have a useful place as adjuncts to the central accounting purpose. It does mean, however, that these special analyses are subordinate to the general function of accounting. Accounting concepts and standards should therefore be based on the purpose of providing information to all interested parties rather than to one group of interested individuals. If the information thus provided is significant, intelligible and useful, each group can base its individual analysis upon the accounting data thus established.

Accounting is the quantitative expression of business transactions. This expression takes the form of accounting entries, made according to a well-defined methodology. In simple terms, accounting entries may be either entries of exchanges or entries which adjust prior or subsequent exchange entries. Expressed in a different manner, accounting entries may be either external or internal. The external entries are the exchange entries, the internal entries are the adjustment entries. The initial accounting treatment of exchanges has been so thoroughly worked out that it has reached an advanced stage of acceptability and usefulness. The concept of the business entity, the continuity of life or "going concern" concept, the concept of measured consideration have assisted in determining the quantitative expression of exchanges as they occur. The prior or subsequent adjustment of exchange transactions revolves around the activities of accounting in presenting a periodic report on the progress of the business enterprise. These adjustment are the main evidence of the analytical phase of accounting function. It is here that accounting procedures are less well-defined. How should the effect of a business transaction be related to the progress of a particular period? Does the exchange have an instantaneous effect during this period, should the effect be recognized in advance of that moment or should it be postponed in whole or

in part? This is the area in which the major accounting difficulties are found. Accountants are striving to set up principles and guides to action that are directed mainly at aiding in the solution of the problem of correctly reporting periodic progress.

This problem area is also the major concern of this study of business transactions. In examining the accounting view of the nature of business transactions, the emphasis rightfully should be placed on this analytical phase of accounting.

The Accounting Problem of Timing

The timing of accounting entries is a complicated proposition. Accounting entries deal with business transactions but they do not serve merely to list them as they occur. Accounting does serve as an adequate record of business exchanges, but its service extends beyond mere recording. Elementary and basic to problems of accounting timing, however, are certain physical considerations. In other words, when a business transaction occurs, it should be entered on the books. Other considerations, such as making accounting entries before the exchange takes place and tracing the effect of the transaction after it has occurred are also vital problems of the timing of accounting entries. These considerations are outgrowths of income determination, and of the assumption that income determination is based on periodicity.

There are three criteria that are important factors in the determination of the timing of any accounting entry. These criteria are basic to the concepts and function of accounting. These criteria are: (1) pertinence or relevancy; (2) measurability; and (3) corroboration. Relevancy means that the entries must have a basis in the facts of the exchange. Measurability means susceptible of expression in money price. Corroboration means that a stage of definiteness has been reached where it is certain that the exchange is an actuality and not merely a possibility. This concept of definiteness has been expressed by some accountants as the idea that accounting data should rest upon verifiable, objective evidence. There is

involved in this concept the connotations of corroboration by independent parties, of dependable supporting evidence and unbiased reliance upon fact. The idea is one of dependable objectivity of evidence opposed to doubtful objectivity of evidence.

The timing of external accounting entries is closely allied to the question of the selection of those business activities that are to be considered business transactions and therefore should receive accounting treatment, and those business activities that are not business transactions and therefore should not receive accounting treatment. A business transaction is recorded when it occurs. The problem is one of determining when the transaction came into being.

A major aspect of timing in accounting is related to income determination. The final result of income determination becomes a quantitative expression of net income or net profit. Net income is the difference obtained by deducting certain items from the gross revenue. Stated differently, net income is the difference between revenue and revenue deductions. The calculation of these two related items, revenue and revenue deductions, has been approached in accounting by distinct and separate avenues. The theory underlying the timing of the recognition of revenue is different from the theory underlying the timing of the recognition of revenue deductions. Basically, the revenue is the controlling figure and the revenue deductions are related to revenue on a casual basis.

The timing problems related to income determination fall naturally into two main groups, those problems that are concerned with the timing of revenue items and those problems that are concerned with the timing of revenue deductions.

The timing of revenue presents three possibilities: (1) The revenue may be recognized at the time the transaction occurs and is entered in the accounts; (2) the revenue may be recognized by an anticipatory accounting entry prior to the occurrence of the actual transaction or exchange; (3) the revenue may be recognized by a subsequent accounting entry which is recorded after the transaction or exchange takes place. The first possibility, because it satisfies the three cri-

teria of relevancy, measurability, and corroboration in the best fashion, has become the accepted theory base for revenue accounting. The second and third possibilities sometimes find expression in accounting as the "production basis" and the "cash basis" for revenue recognition. These are not acceptable theory basis for revenue recognition and their use is an exception to the best procedure. The production basis, for example, is used for long-term construction contracts and in certain extractive industries as an expediency. Likewise, in the case of instalment selling, the cash basis is often used because of the nature of instalment transactions. Instalment transactions are characterized by the high possibility of forfeiture, frequent repossession, and a high expense of collection. Because of these factors, the use of the accepted sales basis for the timing of revenue recognition is likely to prove untrue.

Although revenue is the controlling or dominant factor in income determination, revenue deductions receive more detailed attention from business men and accountants and present more problems of recognition, measurement and classification. The problem of accounting for revenue deductions is primarily one of timing. When shall a cost or expense be deducted from revenue? This is the area where purpose, effect, nature of the transaction, judgment and opinion all play their part.

The problem of the timing of revenue deductions is a choice among three possibilities. The first possibility is an immediate revenue deduction when the exchange or transaction takes place. The second possibility consists of a subsequent deduction from revenue after the transaction has been recorded, accomplished by a subsequent internal entry or entries which trace the continuing effect of the transaction. The third possibility is deduction before the exchange occurs. This is effected by an anticipatory internal entry, recording the effect of the transaction as a revenue deduction prior to the actual exchange.

Income determination for a specific accounting period is the difference between: (1) revenue recognized in that period; and (2) revenue deductions that reasonably can be associated

with that revenue; and revenue deductions that cannot be associated with the revenue but are deducted for other reasons. The association of costs and revenue is based upon the nature of business operations. Efforts (costs) are exerted and accomplishment (revenue) results. If effort and accomplishment occur within the same period, the timing of revenue deductions offers no problem of anticipation or postponement. If no reasonable or practical basis can be established for anticipation or postponement, then recognition and deduction occur simultaneously. There are numerous examples of such expenses. Selling expenses, administrative expenses, and financial expenses are broad classifications of expenses that are ordinarily deducted as they are incurred. The reason for immediate deduction is one based on the complexity of the casual relationship. There is no direct relationship to physical production. This fact makes difficult the assignment of specific costs to specific revenue, and, in most cases, no attempt is made to make any assignment.

The subsequent deduction of costs from revenue after the transaction has been recorded is a procedure that is frequent in accounting, coinciding with the accounting concept of cost recognition, internal tracing, and finally, deduction from revenue. The view that assets are deferred charges to operations results in the subsequent deduction of asset cost as a revenue charge. Subsequent revenue deductions are based on two determinants. The first is a positive determinant. The charge is not made until a subsequent period because the cost is related to the revenue recognized in the later period. The second is a negative determinant. The asset cost is written off at that time in the future when it is determined that the cost has no relation to any future revenue. The former charges are costs and expenses. The latter are losses.

Several specific examples of subsequent revenue deductions are presented in this study. The alternate possibilities of solution are discussed in detail. The best basis for decision as to when to deduct the cost from revenue is the nature of the transaction as tested by criteria of relevancy, measurability, and corroboration. The examples are: (1) depreciation; (2)

obsolescence; (3) addition of the unamortized cost of a retired asset to the cost of a new asset that replaces the old asset; (4) the inventory problem of first-in, first-out versus last-in, first-out; (5) the treatment of unamortized bond discount on refunding; (6) the deferrment of research and experimental costs; (7) amortization of goodwill; (8) amortization of patents; and (9) deferrment of organization and development costs.

The third possibility is an anticipatory revenue deduction prior to the recording of the transaction. Anticipatory revenue deductions are permissible but infrequent. The reason they are infrequent is because of their lack of measurability and corroboration. It must be demonstrated that the costs are relevant to the revenue recognized prior to the exchange. Also the measurement of the amount to be deducted must be determinable on a plausible basis. The advance treatment of exchanges must result in a greater accord with the actual facts than would be true if we wait for the more convincing measurement of exchange. The mere belief that such costs should be recognized and the arbitrary and unscientific apportionment of the estimated amount has no place in accounting. The infrequency with which these deductions are made and the paucity of examples of this type is due to the innate unwillingness of accountants to base their measurement on a forecast of the future and their inability to measure accurately the deduction even though it can be ascertained to be relevant.

The examples of anticipation charges which are discussed in this study are: (1) bad debts; (2) repairs and maintenance; (3) the usual amortization of bond discount; (4) provision for self-insurance; (5) anticipation of retirement costs; (6) provision for guarantees; (6) provision for prospective patent losses; and (7) provision for returns, allowances and discounts.

Related Business Transactions

Business transactions are usually related to some other transaction or transactions. This relationship takes many varied and complex forms. A given transaction may be the

cause for future transactions; it may be the result of past transactions. Accounting in serving as a source of information concerning business transactions, recognizes many of these relationships in its activities of classification, measurement, and analysis. The conduct of modern business is a continuous series of activities directed toward the production of chosen goods and services. These activities result in related business transactions. On the surface these transactions seem separate and distinct exchanges; they seem to be recorded as such by accounting. Because of their relationship, however, accounting gives meaning to their real nature as constituent elements of business conduct in the over-all sense and of specific activities in the functional sense. This is accomplished by a skillfully constructed technique of account classification into which is interwoven the simultaneous use of real and nominal accounts.

Transactions are related on the basis of business activities. The accounting problem of relating business transactions is one of determining the effective or measurable beginning and end of a specific business activity.

Certain specific problems illustrate the general problem of relationship of transactions and of the beginning and end of the specific activity. The problems discussed in this study are: (1) disposition of unamortized bond discount at refunding; (2) disposition of unamortized cost of old asset that is replaced by a new asset; (3) the use of replacement price; (4) gains and losses on treasury stock; (5) appraisal of assets; and (6) quasi-reorganizations.

The accountant should be skeptical of the establishment of indirect or far-fetched relationships. Too often they are excuses to accomplish a desired effect. For example, the relating of old bonds that are retired to the new bonds that replace them may be motivated by a desire to escape a large charge to surplus or revenue, while at the same time achieving a reduction in future interest charges. Likewise, the use of replacement price in place of outlay cost in profit determination may be based on the wish to smooth out the income calculation or to avoid a presentation of a large profit.

The joining of series of transactions should be justified by the nature of the transactions that make up the series of transactions. The indiscriminate or purposeful relating of series of events is not good accounting theory or practice.

The decisions as to the solution of specific accounting problems in which there are strong alternative solutions is not simple. There are certain factors which affect the accountant's decision. These factors are pointed out in the discussion of specific accounting problems. The purpose of the proposed treatment, the effect upon the business, the usefulness of certain new figures, the avoidance of "shock" to the enterprise, the desire to be conservative, these are some of the factors that clearly have their effect upon the resulting solutions of the accountant.

Accounting should not base its theories on factors other than the nature of the facts. Accounting will become a less valuable servant of business if its decisions are based upon non-accounting motives. If we state that the effect of our decision should govern our decision, we make it easy for accounting to lose its reliability and usefulness. For example, if the management does not care for the effect of a given accounting procedure and the accountant falls in line by agreeing that the effect of the treatment is a major item in making the decision, the result may be that the accountant is being governed by the wishes of the management. The door may be thus opened to a great deal of objectionable accounting procedure. We might answer that the integrity and judgment of the accountant will safeguard this misuse of accounting information. Perhaps this is an answer. But accountants are human and do make mistakes. Furthermore, there are unscrupulous accountants as well as honest ones. From every point of view, the best view is the one that holds to the belief that the best accounting procedures are those based upon the nature of the transaction. The other factors are unscientific and therefore unsatisfactory as determinants for accounting purposes. These factors, however, do exist and are important considerations in the solution of certain problems. If their adoption is proposed, it should be clearly pointed out that they

are non-accounting factors and therefore must be supported by other than accounting reasons. The justification must be strong enough to outweigh the obvious merits of good accounting. This is an area where judgment is very important. But it should be noted that judgment—perhaps a departure from standard in a given case—thus has a firm foundation in the facts of the situation from which to begin when establishing a case for a non-standard treatment.

VITA

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